Corporate Taxation, Tax Planning, and Thin Capitalization Rules - Evidence from a Panel of Multinationals

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Extended Abstract

While all companies will respond to taxation and capital market conditions with their financing and investment decisions, multinational companies seem to have enhanced opportunities. In particular, they may be able to structure their internal finances in order to save taxes (Desai, Foley and Hines, *Journal of Finance*, 2004). From a fiscal perspective the drawback is a reduction in taxable fiscal resources. Furthermore, enhanced opportunities for saving taxes may give the multinationals an advantage against companies operating only at a national level. Governments, thus, are tempted to fight back, for instance, by imposing thin-capitalization rules. Whether or not such policies are generally beneficial, is, however, discussed in the theoretical literature since restrictions to tax planning might re-enforce tax competition for investment (*e.g.*, Janeba and Smart, *International Tax and Public Finance*, 1999, Keen, *National Tax Journal*, 2001, and Bucovetsky and Haufler, *CESifo Working Paper*, 2005. But, empirical evidence on the effects of those restrictions on financing and investment is generally lacking.

This paper investigates the effects of thin-capitalization rules on multinationals' financing and investment decisions. The empirical analysis employs a comprehensive micro-level panel database of virtually all German multinationals, made available for research by the German Bundesbank. As in the analysis of Desai, Foley, and Hines (*Journal of Finance*, 2004) the panel

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data structure and the possibility to identify all foreign affiliates belonging to the considered multinational allow us to control for the heterogeneity across companies. A further advantage of the data is that under German tax law repatriated foreign profits are almost completely exempt from corporation taxes such that the taxes at the location of the affiliate are decisive for the financing and investment decisions.

The paper is structured as follows. A theoretical model considers the financing and investment decisions of a multinational corporation and derives empirical implications. More specifically, we model a company, active in two countries, which has the opportunity to use equity as well as external and internal debt subject to thin-capitalization rules. The empirical implications for borrowing and investment are then investigated using panel-data for the period from 1996 until 2003. First results show significant impacts of local taxes as well as local credit market conditions on external and internal financing decisions but also an impact of thin-capitalization rules. Moreover, investment is found to be more sensitive to taxes if debt finance is restricted supporting the theoretical concerns about re-enforced tax competition.